



Economic Impact Analysis Virginia Department of Planning and Budget

11 VAC 10-45 – Advance Deposit Account Wagering

Virginia Racing Commission

June 1, 2004

The Department of Planning and Budget (DPB) has analyzed the economic impact of this proposed regulation in accordance with Section 2.2-4007.G of the Administrative Process Act and Executive Order Number 21 (02). Section 2.2-4007.G requires that such economic impact analyses include, but need not be limited to, the projected number of businesses or other entities to whom the regulation would apply, the identity of any localities and types of businesses or other entities particularly affected, the projected number of persons and employment positions to be affected, the projected costs to affected businesses or entities to implement or comply with the regulation, and the impact on the use and value of private property. The analysis presented below represents DPB's best estimate of these economic impacts.

Summary of the Proposed Regulation

§59.1-369 of the Code of Virginia mandates that the Virginia Racing Commission promulgate regulations and conditions under which horse racing with pari-mutuel wagering be conducted in the Commonwealth. In addition, Chapter 682 of the 2003 Acts of Assembly amended the Code of Virginia to require that the Virginia Racing Commission promulgate regulations and conditions that regulate and control pari-mutuel wagering, permissible under the Interstate Horseracing Act, in which an individual may establish an account with an entity approved by the Virginia Racing Commission to place pari-mutuel wagers in person or electronically. Such regulations are to include (i) standards, qualifications, and procedures for the issuance of a license to such an entity, (ii) provisions regarding access to books, records, and memoranda and submission to investigations and audits, and (iii) provisions regarding the collection of revenues due to the Commonwealth from the placing of these wagers. With the

exception of this method of pari-mutuel wagering, all other wagering on simulcast horseracing is to take place at a licensed racetrack or satellite facility.

The proposed regulation (1) establishes licensure requirements for individuals and entities conducting account wagering in Virginia, (2) specifies operating and other requirements in order for licensees to maintain or renew their license, (3) details the amount of the application fee, the licensure fee, and other fees to be charged by the Virginia Racing Commission (VRC), (4) specifies the distribution of source market fees, (5) establishes penalties for violation of the regulation, and (6) prohibits the use of any computers owned or leased by the Commonwealth or its subdivisions, by public elementary and secondary schools, and by public colleges and universities from being used for making pari-mutuel wagers.

The proposed regulation was adopted as an emergency regulation in 2003.

Estimated Economic Impact

Description of Regulation:

Chapter 682 of the 2003 Acts of Assembly amended the Code of Virginia to require that the Virginia Racing Commission (VRC) promulgate regulations and conditions that regulate and control pari-mutuel wagering, permissible under the Interstate Horseracing Act, in which an individual may establish an account with an entity approved by the Virginia Racing Commission to place pari-mutuel wagers in person or electronically. This form of gambling is known as advance deposit account wagering. Prior to the amendment, advance deposit account wagering occurred in Virginia without any regulatory oversight. The amendment makes it illegal to conduct this type of wagering in Virginia without a license. Individuals will now be legally allowed to place bets by phone or via the Internet to licensed businesses in Virginia and in other states that specifically permit these activities.

The proposed regulation establishes licensure requirements for individuals and entities conducting advance deposit account wagering in Virginia, including the application and license renewal procedures. A non-refundable application fee of \$5,000 is to be paid to VRC at the time of application. The applicant is to be billed for any costs in excess of \$5,000 incurred by VRC in reviewing the application. The application fee is intended to cover, among other things, the cost of a background investigation of the applicant (by VRC or by the Virginia State Police) and the

cost of a review of the application by outside counsel. Licenses are to be valid for the calendar year in which they are issued and applications for renewal are to be received by VRC by 5.00pm on December 1 of each year. In addition to the application fee, individuals and entities seeking a license or seeking to renew their license are required to pay an annual \$1,000 licensure fee. This fee is intended to cover any enforcement costs and the costs to review and monitor the activities of the licensee during the course of the year. Finally, VRC is to receive 0.5% of the gross handle from the source market area (which is the entire state for the purpose of this regulation), to be paid to VRC by the 10th day of each month.

The proposed regulation also specifies the distribution of source market fees. Source market fees are a percentage of the total amount of money bet in the source market area payable by the licensee to the racetrack and to the majority horsemen's association. The percentage is to be based on a contractual agreement between the various parties. In case of a single racetrack licensee, the account wagering licensee is required to distribute the source market fee to the racetrack on the 10th of each month and to the horsemen's association within 48 hours after receiving the money. The regulation also specifies the distribution of source market fees in case of more than one racetrack licensee (this provision is not currently applicable as Colonial Downs is the only licensed racetrack in Virginia). According to VRC, these requirements are similar to those applied in other states, such as California and Oregon, which allow advance deposit account wagering¹.

The proposed regulation also establishes operating and other requirements in order for licensees to maintain and renew their license. Operational requirements include submitting proof to VRC every six months that account holders will be guaranteed the full value of their accounts regardless of the activities of the licensee and other entities, ensuring that all employees working on behalf of the licensee are permitted or licensed by VRC, and submitting quarterly reports detailing all account wagering activity. Other requirements include allowing wagers to be placed only on behalf of established account holders, administrative requirements dealing with opening and managing advance deposit wagering accounts, and record-keeping requirements that allow VRC to review and monitor the activities of licensees. The proposed regulation also establishes penalties for violation of the regulation. Failure to comply with any of the requirements of the

regulation or failure to get a license could result in the imposition of fines and suspensions and criminal or civil prosecution.

Finally, the proposed regulation prohibits the use of any computers owned or leased by the Commonwealth or its subdivisions, by public elementary and secondary schools, and by public colleges and universities from being used for making pari-mutuel wagers. This provision is required under the Code of Virginia.

Estimated Economic Impact:

The proposed regulation is likely to impose additional costs on businesses seeking to conduct advance deposit account wagering. These businesses will now be required to pay a non-refundable application fee of \$5,000, any additional costs in excess of the \$5,000 incurred by VRC in reviewing the application, a license fee of \$1,000 for the issuance and renewal of licenses, a fee of 0.5% of the gross handle from the sources market area to VRC, and a negotiated percentage of the gross handle from the source market area to the licensee racetrack (currently only Colonial Downs) and the recognized majority horsemen's association.

The non-refundable application fee of \$5,000 was determined based on a \$3,000 estimate for outside counsel to review an application (charged at an hourly rate of \$120). Applications tend to be between 500 and 1,000 pages long. In addition, the application fee is to cover the cost of background investigations. According to VRC, the cost of background investigations varies greatly depending on the applicant, with some investigations costing over \$20,000. Any cost in excess of \$5,000 incurred by VRC in reviewing the application is to be covered by the applicant. VRC believes that the non-refundable \$5,000 base fee is the minimum required to cover the cost of reviewing an application. It is also the minimum required to cover costs incurred by the agency when an application is withdrawn midway through the process. In addition to the application fee, applicants will be required to pay an annual license fee of \$1,000 in order to receive or renew a license. This fee is intended to cover the enforcement costs and the cost of reviewing and monitoring the activities of the licensee during the year. Only two other states, California and Oregon, currently allow advance deposit account wagering. According to VRC,

¹ Other than California and Oregon, Washington is currently in the process of enacting a regulation allowing for advance deposit account wagering.

neither of the two states charges an application fee. However, they do charge significantly higher annual license fees.

It should be noted that the proposed fee structure for the application fee could be designed in a more efficient manner. In order for VRC to charge applicants the exact cost to the agency in reviewing an application, it would be more appropriate for the agency require applicants to make a \$5,000 deposit, rather than charging a \$5,000 non-refundable fee. The cost to the agency to review the application, conduct background investigations, and have outside counsel review the application varies from applicant to applicant. These costs could be charged against the \$5,000 deposit. Any deposit in excess of these costs could be returned to the applicant following the review. An economically efficient fee is one that charges an applicant the exact cost incurred by the agency in conducting the review. The proposed fee structure is efficient insofar that it allows the agency to charge applicants any costs in excess of \$5,000. However, it could be made even more efficient by allowing for the refund of any money in excess of the cost of the review.

The regulation also proposes to charge businesses conducting advance deposit wagering 0.5% of the gross handle, to be paid to VRC by the 10th day of each month. Revenue generated from the handle is to be deposited in the State Racing Operations Fund, with any excess revenue deposited in the general fund at the end of each fiscal year. According to VRC, the 0.5% handle is consistent with the license tax charged when wagering at Colonial Downs or a satellite facility and with similar regulations in other states. Applicants are also required to pay a certain percentage of the gross handle to the licensee racetrack and to the horsemen's association. VRC expects between 7% and 8% of the total handle to go to Colonial Downs and another 7% to 8% of the total handle to go the horsemen's association.

According to VRC, Virginians are wagering approximately \$28 million a year. Of this, approximately 80% (or \$22.4 million) are through offshore accounts. There is a great deal of uncertainty in estimating the gross handle from the source market area that the proposed regulation will be successful in capturing. VRC expects the racetrack and the horsemen's association to get approximately \$150,000 each in the first year of operation under this regulation. Future revenues will depend on the number of businesses currently engaging in these activities that choose to become licensed in Virginia.

In addition to the above costs, the proposed regulation is also likely to produce economic benefits. By establishing licensing requirements, the proposed regulation will allow VRC to monitor businesses engaged in advance deposit account wagering and protect individuals utilizing these companies to place wagers from financial and other types of fraud. Businesses involved in advanced deposit account wagering have the potential to create a public hazard by conducting their activities in an improper or inappropriate manner. The aim of the proposed regulation is to enforce certain compulsory minimum standards of operation for such businesses and to reduce the risk to the public from their activities. Thus, the cost of applying for and obtaining a license can be viewed as part of the compliance cost incurred by these businesses to ensure that they do not create a public hazard. Prior to promulgation of the emergency regulation, these businesses were paying none of the costs associated with the risk posed to the public from their activities. This could potentially have resulted in unsuitable and undesirable individuals and entities entering the business. Charging fees that reflect the cost associated with reducing the risk to the public from the activities of these businesses to an acceptable level is likely to result in more efficient allocation of resources.

The net economic impact of the proposed application and licensure fees will depend on whether the fees being charged are commensurate with the risk posed to the public from the activities of advance deposit account wagering businesses. If fees are commensurate with the risk, the proposed application and license fees are likely to lead to a more efficient allocation of resources and produce a positive net economic impact. However, if the fees being proposed are in excess of the cost of reducing the risk to the public, the proposed fees are likely to lead to a waste of resources and have negative economic impact. According to VRC, the fees being proposed are the minimum required to ensure that the risk to the public from the activities of these businesses is reduced to an acceptable level.

VRC is not aware of any problems with businesses that have been conducting advance deposit wagering prior to the promulgation of the emergency regulation. Thus, the extent of the risk to the public from such activities is unclear. By setting a minimum of \$5,000 for the application fee and \$1,000 for the issuance and renewal of a license, the proposed regulation could very well be charging applicants a fee that is in excess of the risk they pose to the public from their activities. As suggested earlier, a fee structure that allowed for the refund of any

unused portion of the application and licensure fee would be more appropriate and would reduce the likelihood of the fees producing a negative economic impact.

In addition to the application and license fees, the proposed regulation also imposes additional costs on businesses conducting advance deposit account wagering in the form of payments of a percentage of the gross handle to VRC, the licensee racetrack, and the horsemen's association. The net economic impact of these payments will depend on whether the benefits to the licensee and to the public from these fees are greater than or less than the proposed costs. While any benefits associated with the application and license fee are in the form of a reduced risk to the public from advanced deposit account wagering, the benefit of paying a percentage of the gross handle to VRC, the licensee racetrack, and the horsemen's association is not readily apparent. While the 0.5% handle fee is necessary in order to ensure that advanced deposit account wagering does not receive a competitive advantage compared to other methods of wagering (a similar tax is charged when wagering in person at the racetrack or its satellite facilities), the benefits of such payments are not clear. Thus, the net economic impact of a percentage of the gross handle being paid to VRC, the licensee racetrack, and the horsemen's association will depend on whether the payment provides the licensee with any benefits (such as improved horseracing and other related services provided by the state, improved racing facilities, and better and more interesting races being run in Virginia) and whether any of these benefits are greater than or less than the additional cost to businesses conducting advance deposit account wagering.

Overall, the net economic impact of the proposed change will depend on whether the benefits of the proposed regulation to the public (in terms of reducing the risk to the public from these activities) and to the licensees themselves (in terms of better horseracing facilities, an improvement in the quality of races, etc.) are greater than or less than the additional cost to businesses conducting advance deposit account wagering. A precise estimate of the benefits of the proposed regulation to the public and to the licensee is not available at this time.

An Undesirable Consequence of the Proposed Regulation:

Section §59.1-369 of the Code of Virginia requires that the allocation of revenues from advance deposit account wagering include a license fee to VRC and be based a contractual agreement between the advance deposit account wagering licensee and (i) the racetrack licensee

and (ii) the recognized majority horsemen's association. Based on the statutory requirement, the proposed regulation requires that all applicants for an advance deposit account wagering license submit a copy of the contractual agreement in order for the application to be deemed as complete and considered for licensure. According to VRC, California has a similar requirement as part of their licensing process.

Since the promulgation of the emergency regulation in August 2003, VRC has received five applications for licensure. However, only one had been approved as of May 2004. The only advance deposit account wagering licensee currently operating in Virginia is Colonial Downs. The application process for the remaining four applicants has not been able to proceed due to the lack of a fee-sharing agreement with Colonial Downs, the only racetrack licensee in Virginia. Colonial Downs is reportedly seeking between 11% and 12% of the total handle generated by account wagering activities in Virginia. Based on the profit margins typically generated by them, advance deposit account wagering companies believe this percentage to be too high. VRC also estimates that the percentage of retainage sought by Colonial Downs would reduce the profit margins generated by these companies to close to zero.

The statutory requirement for a fee-sharing agreement with Colonial Downs, also seeking to establish itself in the advance deposit account wagering business, creates an incentive for Colonial Downs to withhold agreement to any reasonable fee-sharing arrangement. By doing so, Colonial Downs eliminates any potential competition, thus establishing a monopoly in the advance deposit account wagering market in Virginia and maximizing its profits. While monopoly firms earn larger profits, economic theory establishes that, compared to a competitive market, a monopoly market results in an overall loss of efficiency and a waste of resources. The size of the inefficiency is known as the deadweight loss due to monopoly. The market power that a monopoly firm has by virtue of being the sole supplier of certain goods and services allows it to set the price at which it sells these goods and services. The price is set at a level that maximizes the firm's profits. Profit maximizing by a monopoly firm results in the firm charging a price that is higher than the cost of producing the goods and services. Thus, prices tend to be higher and quantity supplied smaller in monopoly markets than in competitive markets. In this case, Colonial Downs is the sole supplier of advance deposit account wagering services in Virginia. Compared to a market with multiple providers these services, a market with only one provider is likely to result in higher prices being charged for these services in Virginia and

consumer choice being restricted in terms of the number and variety of horse races Virginians can bet on using advance deposit account wagering.

Thus, the statutory requirement for a contractual agreement between Colonial Downs and any applicant for an advance deposit account wagering license coupled with the fact that Colonial Downs is also seeking to enter the advance deposit account wagering business creates an incentive for Colonial Downs to refuse to enter into a fee-sharing agreement, thus establishing a monopoly in the market. Failure of advance deposit account wagering companies to reach a reasonable fee-sharing arrangement to-date with Colonial Downs is evidence of that incentive. If Colonial Downs is successful in establishing a monopoly in the market, it is likely to lead to an inefficient allocation of resources and have a net negative economic impact on Virginia's economy. Apart from the overall negative economic impact, other consequences of the statutory requirement for a contractual agreement between the applicant and the racetrack could include a loss of revenues for the state from the 0.5% handle fee (due to fewer races to bet on) and legal challenges to the statute based on anti-competitive and interstate commerce laws.

California, which has a similar requirement, has not faced this problem. According to VRC, three account wagering companies have sought and received licenses in the state. Negotiating a contractual agreement on fee sharing has not been an issue as none of the racetracks have sought an advance deposit account wagering license.

The statutory requirement for a fee-sharing agreement with Colonial Downs and the majority horsemen's association is essentially a subsidy to these entities. Assuming the subsidy is deemed necessary by policy-makers, there are more efficient ways of providing it. Requiring advance deposit account wagering companies to directly negotiate the amount of the subsidy with Colonial Downs and the majority horsemen's association creates incentive problems such as the one discussed in this section. This, in turn, leads to an inefficient allocation of resources.

Efficiency can be improved by having the state collect a percentage of the gross handle as a fee and use it to subsidize Colonial Downs and the majority horsemen's association. This would eliminate any incentive problems faced by Colonial Downs and the majority horsemen's association. The percentage of the gross handle to be retained, and hence the amount of the subsidy to be paid to Colonial Downs and the majority horsemen's association, would be determined by the state. It would be in the state's interest not to limit consumer choice and to

license as many advance deposit account wagering companies as possible, thus maximizing the number and variety of horse races Virginians can bet on using this type of wagering. The larger the number of horse races that can be bet on using advance deposit account wagering, the larger the gross handle and the larger the revenues the state receives from the 0.5% fee on the gross handle. Moreover, by not limiting consumer choice and licensing as many advance deposit account wagering companies as possible, the state will prevent the development of a monopoly and avoid the deadweight loss due to monopoly, leading to a more efficient use of resources. This, more efficient, outcome will be achieved while still providing Colonial Downs and the majority horsemen's association with a subsidy in the amount policy-makers deem necessary. Thus, having the state collect a certain percentage of the gross handle as fees and use the fees so collected to provide subsidies to Colonial Downs and the majority horsemen's association will lead to more efficient allocation and use resources than the fee-sharing agreement currently required under the Code of Virginia.

Businesses and Entities Affected

The proposed regulation will affect all businesses and entities seeking to conduct advance deposit account wagering in Virginia. These businesses will now be required to obtain and maintain a license in order to be able to conduct these activities. The additional costs include a \$5,000 non-refundable application fee, payment of any costs in excess of \$5,000 incurred by VRC in reviewing the application, a \$1,000 annual fee for the issuance and renewal of a license, payment of 0.5% of the gross handle from the source market area to VRC, and payment of a negotiated percentage of the gross handle from the source market area to the licensee racetrack and the recognized majority horsemen's association.

There are 28 businesses currently operating in the United States that conduct advance deposit wagering activities. VRC currently has applications pending from five of these businesses. The agency expects two or three more applications in the future.

Localities Particularly Affected

The proposed regulation will apply to all localities in the Commonwealth. However, it is not likely to impose any additional costs on localities.

Projected Impact on Employment

The proposed regulation is not likely to have a significant impact on employment. To the extent that the proposed regulation captures some of the gross handle from betting by Virginians, it could lead to a shift of employment toward horseracing-related activities.

Effects on the Use and Value of Private Property

Businesses conducting advanced deposit wagering activities will now incur additional licensing and other costs, lowering their asset value. However, by establishing standards of operations for such businesses, the proposed regulation could encourage more Virginians to use advance deposit account wagering, mitigating some of the negative impact on the asset value of businesses engaged in these activities. The proposed regulation is also likely to provide additional funds to the licensee racetrack (Colonial Downs) and to the horsemen's association, raising the asset value of these businesses.